THE REAGAN ECONOMIC PROGRAM AND HIGH INTEREST RATES

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 17, 1981

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

88-759 O WASHINGTON: 1982

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

J841-8

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THE REAGAN ECONOMIC PROGRAM AND HIGH INTEREST RATES

THURSDAY, SEPTEMBER 17, 1981

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representative Reuss; and Senators Jepsen, Mattingly, Proxmire, Kennedy, and Sarbanes.

Also present: James K. Galbraith, executive director; Bruce R. Bartlett, deputy director; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, assistant director; and Mark R. Policinski and Keith B. Keener, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for another one of its hearings into the high interest rates and the state of the Reagan economic program.

Immediately before President Reagan's inaugural, two of the Nation's leading supply-side economists—David Stockman and Jack Kemp—got out their famous Dunkirk memorandum. There, they predicted that unless a sensible economic program was put into effect promptly, the Nation would face an economic Dunkirk.

How right they were. Instead of putting into effect a sensible program, the President put into effect the supply-side program of Mr. Stockman and Mr. Kemp.

And now we do face an economic Dunkirk—unconscionably high interest rates, badly damaging housing, construction, small business, farmers, capital investment, the stock and bond markets, municipalities, the whole economic world.

The Reagan-Stockman-Kemp program was designed with the support of business, lobbied through by business, and its enactment celebrated throughout the business community scarcely 6 weeks ago.

But now, with interest rates still grotesquely high, with the stock and bond markets in shambles, and with further critical signs on the horizon, confidence in the President's program is waning.

That the Emperor wears no clothes is now as apparent to all as it was to the Democratic members of this committee who unanimously in our annual report of last March 2 pointed out that the President's program was unrealistic, contradictory, and would not work. The

press will remember the opening statement of our March 2 report [1] in which we, the Democratic members of the Joint Economic Committee, said that the administration's program deserved prompt, thorough and fair-minded consideration by the Congress. Much of it, such as the call for liberalized depreciation, for regulatory reform, for budgetary control, is exemplary; but there are important differences between the administration's program and our own.

One, the administration believes that the Federal Reserve should continue to lower the monetary targets in this critical year of 1981 while we oppose such action. Interest rates are too high now and will remain too high if the Federal Reserve continues to tighten its monetary targets even though control over inflation has not been achieved.

Two, the destructive fiscal facet of the administration's program is the proposed huge individual income tax cut amounting to more than $140 billion per year when fully effected. The assertion that this radical tax cut will trickle down and magically produce full employment without inflation is simply not true. Instead, we urge a moderate cost effective tax reduction to offset the payroll tax increase and a depreciation tax cut followed by watchful waiting. When the budget and inflation are brought under control the benefits should be promptly distributed to the taxpayer but in a fair and equitable way.

Three and last, the administration's program does not sufficiently recognize the structural nature of our problem of investment, jobs, and prices. Investment and job-making programs, including employment training, economic development and infrastructure.

The administration relies on a wholly unproven theory that revised expectations by themselves will conquer inflation. We urge a comprehensive strategy to stimulate investment and jobs.

So there was a difference between the administration's views and those of the Joint Economic Committee Democrats. We offered cooperation. We said in our report that "these are not irreconcilable differences. We approached the administration in a spirit of compromise and we look forward to working together toward a common ground."

Now here we are in mid-September and all wait for the next shoe to drop. The President cannot have his military buildup, his unraveling of the tax system, his tight money policy, and his balanced budget all at once. Which is he going to give up?

Instead of starting over and doing it right, and thus avoiding an economic Dunkirk, the administration is now lashing out wildly, seeking scapegoats for its errors.

Some 40 million investors are understandably worried about the endless budget deficits that Reaganomics is bringing us. All of this, somewhat churlishly, is blamed on Wall Street by the administration, thus biting the hand that has traditionally fed it.

The Federal Reserve, an institution for which I do not often express compassion, has been tongue-lashed for months by the administration to tighten money even more. It is now rewarded for its faithful compliance with administration commands by being denounced by the President and his cohorts for the high interest rates it's bringing us. It is as if Charles Dickens' Fagin, having taught the young to steal, turns them over to the juvenile authorities.

[1] See the 1981 Joint Economic Report, report of the Joint Economic Committee, Congress of the United States, on the January 1981 Economic Report of the President.

Failure seems to have gone to the head of the supply-siders. Not content with having foisted one freakish idea upon the Nation, they are now beating the drums for a return to the gold standard as the only way to avoid an economic Dunkirk.

But enough. We are privileged today to have with us this morning Walter W. Heller, regents' professor of economics at the University of Minnesota, and an esteemed adviser to this committee.

Senator Kennedy, I think you have a statement to make.

OPENING STATEMENT OF SENATOR KENNEDY

Senator KENNEDY. Thank you, Mr. Chairman.

I just want to join in welcoming Professor Heller again to the Joint Economic Committee. He's been a close friend to this committee over the years and a wise counselor to all who care about the soundness of our economy and the prosperity of our country. More than ever we need his counsel now. When the economy is wrong, nothing else is right. As we survey the national economic landscape today, it is increasingly clear that monetarism and supply-side economics just do not mix. Tensions between these conflicting policies and mutually inconsistent ideologies have already triggered the highest interest rates since the Civil War. Now they threaten to saddle the country with the largest deficits in our history. Far from a balanced budget in 1984, the chairman of the House Budget Committee has actually suggested the deficit that year will be over $60 billion and will reach the incredible level of $97 billion in 1985. That's just plain irresponsible.

Our economy has certainly seen better days. Walter Heller was one of those who had a clear vision and good sense that we need today. As Chairman of the Council of Economic Advisers under President Kennedy, he was the architect of a new economics that made sense in theory and that work brilliantly in practice, and the policies he set in place gave America the longest uninterrupted period of growth and price stability in our history, and I'm pleased to welcome you here today and look forward to his analysis of the challenges that we face.

Representative REUSS. Our distinguished members, Representative John Rousselot and Senator Paula Hawkins have opening statements, which under the rule and without objection will be admitted in full into the record.

[The opening statements of Representative Rousselot and Senator Hawkins follow:]

OPENING STATEMENT OF REPRESENTATIVE ROUSSELOT

Mr. Chairman, high interest rates restrict the creation of new wealth. High financing costs reduce profit margins, and make new construction, factory rennovation, and home ownership more expensive. The high cost of capital makes it difficult for the poor to financially succeed.

The present high interest rates have many causes. Federal taxation, unbalanced budgets, and the uncertainty and devaluation of the Nation's currency, contribute to the high cost of borrowed money.

Excessive taxation often requires farmers, manufacturers, developers, and other individuals to borrow money to meet expenses they would have been able to afford were it not for losing much of their income to the Federal Treasury. In tax year 1980, a married couple, earning a taxable income of $43,200, filing jointly, paid 49 percent of their marginal income in Federal taxes, discouraging work for savings and capital formation.

To make matters worse for the borrower, the Federal Government crowds out much of the available credit. In fiscal year 1980, the Federal Government raised $124.4 billion from the private credit markets. In terms of total funds raised in U.S. credit markets, the Federal Government consumed 36 percent of all available funds. Inserted is a ten-year table showing Federal borrowing relative to total borrowing.

Private credit absorption and taxation are serious problems which need to be addressed by Congress. In addition, the Federal Reserve should fully announce and adopt a consistent, noninflationary, monetary growth policy. The Nation's supply of coins, currency, and checkable deposits should not grow faster than the Nation's production of goods and services if inflation is to be repealed and if bankers are to become confident that they can profitably lower interest rates to borrowers.

It is my hope that this hour serves as a forum for inexpensive credit.

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CREDIT ABSORPTION BY PRIVATE AND GOVERNMENT BORROWERS

(Fiscal Years, Billions of Dollars)

	1971	1972	1973	1974	1975	1976[5]	1977	1978	1979	1980
TOTAL FUNDS RAISED (borrowed) IN U.S. CREDIT MARKETS[1]	125.7	163.5	207.7	193.4	181.3	251.8	314.4	385.3	414.3	344.7
Individuals,[2] Corporations & Foreign[3] Borrowers	78.9	109.9	147.9	152.5	105.0	132.7	213.7	264.0	314.7	200.9
Government Borrowing										
-Raised under Federal Auspices	33.5	40.0	47.5	24.4	64.9	98.2	79.6	94.4	81.7	124.4
--federal borrowing from public	19.4	19.4	19.3	3.0	50.9	82.9	53.5	59.1	33.6	70.5
--guaranteed loans	16.1	19.8	17.7	10.5	8.7	11.2	14.0	13.9	26.1	32.4
--government-sponsored enterprise borrowing	-2.1	0.7	10.6	10.9	5.3	4.1	12.0	21.4	21.9	21.4
-State and Local Borrowing	15.0	15.4	13.7	17.9	12.4	20.6	20.7	28.5	19.6	23.6
-Total Raised by All Levels of Government[4]	46.8	53.6	59.8	40.9	76.3	119.1	100.7	121.3	99.6	143.8
PERCENT ABSORBED BY ALL LEVELS OF GOVERNMENT	37%	33%	29%	21%	42%	47%	32%	31%	24%	42%
AVERAGE FOR ALL TEN YEARS					33.8%					
THREE-YEAR AVERAGE, 1978-80									32.3%	

1/ Non-financial sectors. Sources: Office of Management and Budget and Federal Reserve Flow of Funds Accounts.

2/ Includes Households, Farms and Nonfarm-Noncorporate Business

3/ Foreign individuals, businesses and governments raising funds in U.S. credit markets. The foreign total has averaged about $20 billion a year the past five years.

4/ Totals adjusted to deduct double counting of Federal guarantees of tax-exempt obligations. For 1980 this adjustment is $4.1 billion but averages about $1.5 billion for all other years.

5/ Transition quarter 1976-1977 eliminated.

NOTE: TOTALS MAY NOT ADD DUE TO ROUNDING.

Source: Charles H. Bradford, Joint Economic Committee, using data provided by the Office of Management and Budget.

OPENING STATEMENT OF SENATOR HAWKINS

THE FEDERAL GOVERNMENT ACCOUNTS FOR ABOUT ONE-THIRD OF ALL BORROWING IN THE CREDIT MARKETS -- $124 BILLION OF $345 BILLION IN 1980 IF YOU INCLUDE LOAN GUARANTEE COMMITMENTS. WE THINK THE REAGAN PROGRAM OFFERS A WAY OF REDUCING THIS FEDERAL "OVERLAY", WHICH WILL AFFECT BOTH INFLATION AND INVESTMENT RATES. BUT FURTHER BUDGET CUTS WILL BE DIFFICULT, AND KEEPING THE LEGISLATED TAX CUTS IN PLACE IS IMPERATIVE.

OVER THE NEXT FEW MONTHS CONGRESS WILL BE LOOKING FOR ALTERNATIVE, LESS PAINFUL, ROUTES TO LOWER INTEREST RATES. URGING THE FED TO MOVE THE M1-B MONEY AGGREGATE ABOVE THE LOWER EDGE OF THE FEDERAL RESERVE'S TARGET RANGE IS ONE. THERE IS TALK OF GENERAL CREDIT CONTROLS. A 90 DAY FREEZE ON OFF-BUDGET BORROWING HAS BEEN SUGGESTED. AND SOME IN CONGRESS ARE PROPOSING WINDFALL PROFITS TAXES ON INTEREST PROFITS ABOVE THE RATE OF INFLATION.

I AM NOT ENAMORED WITH ANY OF THESE PROPOSALS, BUT THEY ILLUSTRATE THAT THERE WILL BE A LOT OF TALK DURING THE REST OF THIS YEAR AS CONGRESS SCRAMBLES FOR WAYS OUT OF OUR ECONOMIC TROUBLES.

WE MUST KEEP THE LONG-RUN, "BIG PICTURE" PERSPECTIVE. THE ECONOMIC RECOVERY PROGRAM WILL LEAD TO LOWER INTEREST RATES AS IT SOLVES OUR BROADER ECONOMIC PROBLEMS. THE TAX CUTS, WHICH GO INTO EFFECT ON OCTOBER 1, AND THE REGULATORY REFORM THAT IS GOING ON RIGHT NOW WILL PROVIDE STRONG INCENTIVES FOR CAPITAL INVESTMENT WHICH IN TURN WILL PUT US BACK ON THE PATH OF THE DYNAMIC PRODUCTIVITY GROWTH RATES OF EARLIER YEARS. AT THE SAME TIME, THE ADMINISTRATION, THE CONGRESS, AND THE FEDERAL RESERVE CAN MAKE A HUGE DENT IN INFLATION AND INTEREST RATES BY

CONTINUING A COURAGEOUS POLICY OF FEDERAL SPENDING RESTRAINT AND RESTRAINED GROWTH IN THE MONEY SUPPLY.

OF PRIMARY IMPORTANCE IS CONSISTENT AND PERSISTENT ECONOMIC POLICY. WE EXPECT THE RESULT TO BE IMPROVED LIVING STANDARDS FOR ALL AMERICANS.

YOU ARE IN AN EXCELLENT POSITION TO HELP US WORK OUT ANSWERS TO A NUMBER OF QUESTIONS.

WHAT WE NEED AT THIS TIME ARE POSITIVE ALTERNATIVES. FOR EXAMPLE: (1) HOW WOULD YOU REDUCE INFLATION?

- o WOULD YOU INCREASE THE MONEY SUPPLY? BY HOW MUCH - 2%, 3%?
- o WOULD YOU CUT THE BUDGET? BY HOW MUCH? WHERE WOULD YOU CUT?
- o WOULD YOU RAISE MARGINAL TAX RATES? BY HOW MUCH?

(2) HOW WOULD YOU ATTACK HIGH INTEREST RATES?

- o IS THERE SUCH A THING AS AN "INFLATION PREMIUM" ON THE INTEREST RATES? HOW WOULD YOU GET RID OF IT?

Representative REUSS. Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

I'm pleased to join with the other members of the committee in welcoming Walter Heller before us this morning. He's been a very valued adviser to Presidents, to this committee and to other committees of the Congress, and is a very powerful and constructive force on economic thinking in this country.

Mr. Chairman, I just want to observe that under the auspices of this committee and acting as the chairman of the Subcommittee on Investment, Jobs, and Prices, during the August recess I held six hearings across Maryland on the impact of the high interest rates.

Representative REUSS. Would the gentleman yield?

Senator SARBANES. Yes.

Representative REUSS. As chairman of the committee, I'm very grateful to the gentleman for his outstanding job in those hearings. I am familiar with the testimony of some of the witnesses. In fact, I put a summary of it into the Congressional Record yesterday and I think the gentleman has done a real public service.

Senator SARBANES. I appreciate that very much, Mr. Chairman.

Those hearings enabled us to get testimony at the grassroots level from the people actually being affected—automobile dealers, small business, homebuilders, realtors, farmers—on the effect of the high interest rates on their activities. I just want very quickly to make two or three points that I think came through very clearly in those hearings.

First, the high interest rates obstensibly designed to check inflation are themselves an important contributing factor to the inflation. In other words, a policy put into place to accomplish a certain objective is functioning in a counterproductive way. The high costs of money, of course, are fed into the price level and reflected in the Consumer Price Index, and I should only note that the single most important factor in last month's Consumer Price Index, which was 15 percent on an annualized basis, was the housing sector, which is, of course, very closely tied to the interest rate situation.

Second, the high interest rates are a significant obstacle in two respects to the effort to reduce the Federal deficit. There's a tremendous focus on the deficit at the moment, and yet it's not being underscored that the high interest rates substantially increase the carrying charge on the existing debt. It has far exceeded any projections which this administration made with respect to that item in the budget; and further, by provoking a recession in certain sectors of the economy, the high interest rates are causing people to be laid off, dropped from the employment rolls, they therefore cease to be wage earners and taxpayers and make payments into the Treasury, become idle and draw unemployment—in other words, take payments out of the Treasury. So you have the double impact of the high interest rates—they have in effect contributed to the deficit both by reducing Federal revenues and increasing Federal expenditures.

It's also clear that they are acting as a disincentive to productive investment and the effort to improve efficiency. People are simply not making the decisions that ought to be made in terms of wise economic and business judgments.

It's extraordinarily important to recognize that the high interest rates are actually working against the goals which they are intended to advance. I think it's imperative that the administration recognize this, change its own position in this matter, and then in turn seek to bring about a moderation or an accommodation by the Federal Reserve on this critical issue.

I'm very pleased that Mr. Heller is here this morning. I look forward to hearing from him.

Representative REUSS. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

I welcome Mr. Heller. I'm delighted to see you. You're not only a brilliant economist but I think you're the best communicator—that's a widely used term as you know now—best communicator among the economists that there is. You, more than anybody I know, can make the dismal science not only understandable but interesting, and that's a great feat.

I would be very interested in knowing—taking a little different tone than my colleagues here—knowing how you compare your experience, which Senator Kennedy has said seemed to be a successful experience at that time, in calling for a big tax cut in 1963 and 1964 which we passed in 1964, as you know. I voted against that because I thought it would be inflationary. I voted for this latest tax cut, but I'd like to know how you explain what's happened over the last 20 years when we've had consistent deficits—only one tiny surplus in 1969 and a series of highly inflationary deficits—and then how you also would meet the assertion by the Congressional Budget Office, Ms. Rivlin, whom I'm sure you respect highly and is not a spokesman for the administration, who says the major reason for projected improvement in economic growth which they project over the next 3 years and moderation of inflation which they also project, are the reduction in taxes contained in the Economic Recovery Act of 1981. They seem to feel as far as moderating inflation and as far as economic growth is concerned that the tax cut was a wise move and a constructive move and they think it will be effective. That was September 10, only a week ago, that Ms. Rivlin presented that to the Budget Committee.

Representative REUSS. All right, Mr. Heller. Your prepared statement is much appreciated and will be placed in full into the record. Would you now proceed in your own way and thank you for your patience and rapt attention in listening to us. We will give you as good as you gave us.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA, MINNEAPOLIS, MINN., AND FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. HELLER. Mr. Chairman, let me first express my appreciation for the warm welcome and kind words with which I have been greeted this morning. I have been privileged to testify before this committee ever since its inception and always enjoyed it and found it one of the most constructive undertakings that goes on here in Washington, and I'm delighted to be here again this morning.

By the way, I will respond later on to Senator Proxmire's inquiries. I don't address them directly in my prepared statement, but I will be happy to consider both of those questions. The 1964 tax cut is one of my most favorite subjects and I will be happy to address myself to it.

Well, grim reality is beginning to replace the false hopes and illusions of Reaganomics. It was to be alluringly easy to cut taxes to the bone, sharply boost defense spending, and rely on the Federal Reserve and supply-side miracles to put a damper on inflation.

It wasn't the conservative old-time religion of putting the economy through the wringer by restrictive fiscal-monetary policy to squeeze inflation out of the system. Instead, we were offered the radical new faith that Reaganomics could simultaneously deliver robust growth, ebbing inflation and interest rates, and balanced budgets. No hard choices, no tough tradeoffs in the economic wonderland that zealous supply siders and monetarists—united in shotgun marriage—offered the Reagan White House. It was, and is, unreal.

What are the realities that now emerge out of the President's tax and budget cutting victories and the triumph of monetarism in Federal Reserve policy?

First, towering deficits. Over the next 5 years, tax cuts of $750 billion—maybe that's rounded upward a little bit—but coupled with $150 billion of added defense spending will simply swamp the $250 billion budget cuts thus far enacted.

By the way, I think, Mr. Chairman, we make a bit of a mistake simply stressing that $750 billion number for the next 5 years. What we should recognize is the progression of the cost of those tax cuts, and I'm sure this committee knows that in 1984 they will cost $150 billion; in 1985 they will cost $200 billion; and in 1986 they will cost $267 billion a year. And I think that progression is what we have to bear in mind in thinking about the outyears of the impact of the Reagan tax program.

The CBO estimate of a $50 billion deficit by 1984, which was made September 10, as Senator Proxmire said, is at the low end of the forecasting range, at least outside of the White House and OMB.

Next are the towering interest rates. In spite of a current down tic in interest rates, a tight-fisted Federal Reserve policy clashing with a highly expansionary fiscal policy will keep interest rates on a high plateau as far as the eye can see.

The third result is a fits-and-starts economy operating, on the average, well below its potential. Three years of next to no growth—real GNP at the end of 1981 will be only marginally—about 2 percent—above its level at the beginning of 1979—these slack, slow, sluggish years have already been offered as a sacrifice on the anti-inflation altar. And a progressive slowdown in monetary growth pledged by the Fed and supported by the White House will nip future expansions, if not in the bud, long before full bloom.

That these realities should come as a surprise to the White House and the financial markets is itself surprising. To be sure, interest rates are higher and the tax cut was more massive than projected—former Defense Secretary James R. Schlesinger puts it rather well, if a bit strongly, when he says that the 1981 tax cut is "likely to go down in history as the single most irresponsible fiscal action of modern times"—but the inherent contradictions of Reaganomics were

apparent long ago. Let me take the shortcut of quoting some excerpts from my March 19 appraisal. "U.S. Economic Policy and Outlook," that was coauthored by George L. Perry and published by the National City Bank of Minneapolis. I note this was a couple of weeks after the Joint Economic Committee statement that you were citing. Obviously, it comes as no surprise to this committee.

> The basic problem with the Reagan approach is that it is internally inconsistent. In the absence of any direct attack on the price-wage spiral, one cannot expect brisk recovery, receding inflation, and falling interest rates to co-exist.
>
> The Reagan plan . . . puts an expansionary fiscal policy on a collision course with a contractionary monetary policy. Indeed there is some basis for the impression that Mr. Reagan is relying on fiscal policy to boost demand and speed recovery, monetary policy to curb inflation, and supply-side policy to promote long-run economic growth.
>
> But unfortunately, the economic world does not work in this neatly compartmentalized way. Fiscal stimulus will expand jobs and output, but it will also tend to prop up prices and wages. Tighter money will cut into demand inflation, but its main impact will be to cut into jobs and output, raise interest rates, and discourage investment. And supply-side responses will be far too weak to lead the economy out of this dilemma.
>
> If Fed policy holds to its indicated policy of containing nominal GNP growth, the Reagan economic scenario is seriously flawed: neither nominal nor real GNP will be allowed to grow as fast as that scenario projects. And both deficits and interest rates will be higher than it projects. The conflict is fundamental: until inflation is substantially lower, monetary policy as currently targeted will frustrate Mr. Reagan's "new right" policy for economic expansion.

The major focus of today's economic frustrations is found in interest rates that keep setting new highs not just in nominal terms, but in real terms. Before considering some methods of damage control, it may be useful to remind ourselves of the extensive damage that high interest rates are inflicting on the economy. If those interest rates are the price of curbing inflation, that price is mighty high indeed.

Among the damaging impacts and high costs of our towering interest rates, one should bear in mind the following:

First, the impact on levels of economic activity. The most obvious impact of unrelenting monetary restriction is the suppression of economic expansion. In a sense, as you've noted, it is hard to blame the Fed for this. The Reagan administration has no anti-inflationary program of its own—except for some long-run impacts of deregulation and investment stimulus. In fact, it has a proinflationary fiscal program. The job of curbing inflation and in the process taking the zip out of economic expansion, is assigned to the Fed.

Second, the impact on investment. The conflict between fiscal and monetary policy is typified even more sharply in the area of business investment. The most generous tax breaks for savings and investment in U.S. history—and now one of the most liberal tax treatments of investment in the industrialized world—show no signs of being able to overcome the stultifying effect of high interest rates this year and next. The recent Department of Commerce survey, confirmed by the Conference Board survey, shows business fixed investment flat—stagnant—in real terms for 1981–82, even though the tax cuts for business take effect as of the beginning of 1981.

The brutal impact on housing and autos is so well known—as to require no comment.

The impact on thrift institutions, small and medium business, and State-local governments: Here again, forced mergers of savings and

loan companies, a rising tide of bankruptcies, and shattering impacts on State-local borrowing are all too apparent.

Impacts on foreign economies: Our high interest rates are forcing restrictive policies on our trading partners that account in significant part for their stagnant economies, which of course comes back to our exports situation. The LDC's are also finding the refinancing of their dollar debts a grievous burden.

Impact on cost inflation: as monetary policy pushes money costs to business and home buyers into the 14–25 percent range, one cannot ignore the fact that its role in damping down demand inflation—which incidentally has not been our problem since 1979—comes at an ever-increasing price of higher cost inflation. The rise in net interest burdens of nonfinancial corporations is one case in point: from an average of $40 billion a year in 1976–79, that burden rose to $56 billion in 1980 and was running at a rate of $62 billion in the first half of 1981. One might note that this huge debt burden tends to give business a vested interest in inflation—a sudden drop in price advances in the face of soaring fixed charges on business debt would put a tremendous squeeze on profit margins. What we are witnessing is a transfer of the risks of inflation from the lender to the borrower. The other case in point is that of mortgage financing costs—now exceeding 18 percent—which have a magnified impact on the consumer price index.

I'd like to spend a little bit more time on the question of the impact of high interest rates on the budget. Interest costs are the fastest-rising and least-controllable major component of the Federal budget. In the past decade we have had an 11 percent rate of increase in the budget as a whole and 15 percent for transfer payments and 19 percent for interest costs. For fiscal years 1981 and 1982, ballooning interest rates represent a significant part of the ballooning deficits that are leading to such intense pressure for budget cuts.

It is already apparent that superhigh interest rates operate with sharply differential impacts on various segments of the economy. Certainly that has come out in the course of Senator Sarbanes' hearings in Maryland. It is worthy of special note that there is a fairly systematic bias as between the economically strong businesses and individuals that can in good part shield themselves—or actually profit—from high interest rates and the economically weak units that bear the brunt.

As CBO puts it in its September 10, 1981, report:

> For business firms and individuals in high income-tax brackets, real aftertax interest rates may not have risen sufficiently to dampen their business activities severely. The impact varies greatly, however, depending on the tax situation. For business firms that have little or no profits, the real costs of borrowing are significantly higher.

Even more patently, high interest rates form a part of a pattern of shifting burdens from the upper to the lower income groups that is now in process with a vengeance. Granted, high interest rates stack the deck against the poor and near-poor in somewhat more subtle ways than denying them net tax cuts—while conferring generous tax cuts and lavish "tax expenditures" on the well-to-do—and cutting CETA, food stamps, medicaid and the like. First, they are hurt as net debtors or would-be debtors who want to buy a car or house. Second, they will be the primary targets of further budget cuts required to offset the unanticipated rise in fiscal 1982 interest on the public debt ($10.3 bil-

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lion between March and July and another $5.5 billion since July). And, Senator Sarbanes, I might note that I'm just talking there about the direct, and not the indirect, costs of those higher interest rates. And third, monetary restriction used as a more traditional anti-inflation instrument to curb inflation by slack and slow growth will put those at the bottom of the employment ladder once more into the front lines of our defenses against inflation.

And it should be recognized that the cutbacks in social programs arising out of the grinding combination of excessive tax cuts, big defense boosts, and high interest rates are not just a human issue but an economic issue. Diminished investment in infrastructure, in health safety, education, training and research, ignores the true secret weapon of 20th century American economic growth, namely, investment in human capital. The recent Conference Board Colloquium on Alternatives for Economic Policy—while agreeing on the necessity of budgetary trimming, deregulation, and stimulation of business capital formation—returned to this theme again and again. As the report on the Colloquium, U.S. Economic Policy Issues for the 1980's, stated: "A pervasive feeling, running through the record of the colloquium, is that the issues of human capital in the United States have received much too little attention for much too long a time." There was deep concern with the problem of putting "more emphasis on human capital development as a necessary complement to measures to encourage more physical capital investment." All told, Reagonomics has been moving in the opposite direction.

Before turning to some reasoned steps that might be taken to improve the interest rate outlook, one should perhaps refer to the supply-siders' remedy for our economic problem. The most vocal and strident of their number demands, first, the public flogging of Under Secretary of the Treasury Beryl Sprinkel, and second, a return to the gold standard. I regard these two proposals as equally plausible and feasible.

The gold standard is offered, in effect, as the ultimate discipline for monetary policy, for keeping the Federal Reserve on the straight and narrow path of relentless monetary restriction. It would apply the old-time religion with a vengeance requiring such monetary stringency in the face of inflation as to plunge the economy into a Thatcher-like depression. And with gold supplies expanding only about 1.5 percent to 2 percent a year, a strict gold standard would really be a formula condemning the world to a grindingly slow average rate of growth. Or, if the United States were to go it alone on the gold standard, the inflows and outflows of gold—controlled in part by South Africa and the Soviet Union—would give us anything but monetary and economic stability. I recognize that various discretionary devices could be built into the gold exchange standard to avoid thus being crucified on a cross of gold. But by the time the various exceptions are built in to avoid the most brutal impacts of a rigid gold standard, why go to gold?

Along what avenues can we hope to find some relief from the relentless regimen of high interest rates that the logic—or illogic—of Reaganomics is fastening on us?

First, the Fed itself should now be in a position to show a little self-restraint in pushing for further monetary restraint. Granted, it is

mighty hard to read the money supply tea leaves—one of the inherent defects of monetarism. But with M–1B—both adjusted and unadjusted—running below the Fed's targets—even with M–2 running a bit above—there seems to be some technical leeway for a bit of relief. Also, with overall economic activity relatively sluggish, and with favorable breaks on the inflation front—oil, food, and housing prices, and import prices being the main cases in point—some letup in Federal credit stringency is now in order. This would not relieve us of the basic contradictions in Reaganomics, but would allow some easing of interest rates in the short run.

BUDGET CUTS

Some further cuts are already scheduled by the White House to be part of the program to relieve pressures on the Fed and to allay the fears of the financial markets—which have already caused an erosion of over $200 billion in asset values. But the going will be tough, both in the political sense of breaking faith with those, in Congress and out, that have been promised a vigorous defense buildup and those who had been assured—or thought they had been assured—that severe further inroads on social programs were not on the White House agenda.

In the light of these constraints, the pressure for tax increases will and should grow.

Removal of some tax preferences or tax expenditures should have high priority. Elimination of the deduction of interest on consumer debt could bring in $6 billion a year. A $5,000 lid on deduction of mortgage interest could add another $4 billion. Adding half of social security benefit payments—to taxpayers with incomes above $15,000—adding that into the taxable base would yield $4.5 billion a year. Some limit on the exemption of contributions to employer health plans; application of withholding to interest and dividends; a serious drive to bring the underground economy above ground for tax purposes; elimination of tax deductions for State retail sales taxes paid—these and other measures would yield substantial revenues while improving equity and resources allocation. Also, on the revenue agenda should be higher user fees, for example, in commercial aviation, waterways, irrigation projects, and boating; a windfall profits tax on deregulated natural gas; and boosts in excises on liquor, tobacco, and gasoline.

All of those would pale by comparison to what I think would be a most desirable action which would be to rescind the third-year 10-percent tax cut and eliminate tax indexing. Those would be the best moves toward more responsible budgeting and lower deficits. Politically feasible? Well, probably not yet. As a result there will, of course, be growing talk of a progressive value-added tax in the next few years.

The next measure to take is some credit guidance. Although one shies away from direct credit controls, a few "words to the wise" from the Federal Reserve Board to the banking community could help conserve the existing money supply and direct it to productive rather than nonproductive investment. Surely, an administration that has no hesitation in providing multiple tax guides to investment, savings, and the like should not find it inconsistent to go along with some credit guidance.

The chairman of this committee put it succinctly and well when he said on the floor of the House last July 28:

> All branches of Government ought to encourage our banking industry to soft-pedal loans for commodity speculations, for corporate takeovers, for excessive foreign lending, and thus encourage more money to be available, and at lower interest rates, for housing, construction, capital investment, farmers, small business, and the thrift institutions.

This approach can logically be thought of as the counterpart to the tax guidance so liberally practiced by the White House and Congress in the Economic Recovery Act of 1981, the most deliberately unneutral tax act in the country's peacetime history. I put in the word "peacetime" because the 1943 tax cut was probably a little more unneutral but that was vetoed by President Roosevelt who called it "tax relief not for the needy but for the greedy." The 1981 action brings echoes, it seems to me, of that blazing statement. But just think of the guidance. Savings are guided—almost bludgeoned—into all-savers certificates. Business funds are lured into buildings, oil refineries, and long-lived structures generally by 15–10–5–3. Funds are guided into public utilities through tax-free dividend reinvestment. Moribund companies are given succor through juicy tax-sheltered leasing arrangements. To guide into constructive and productive uses the loanable funds generated by Federal Reserve policy is surely no greater interference with private market resource allocation than the powerful tax guidance encoded in the tax cut.

I am not yet ready to go beyond such gentle credit guidance—or perhaps one could call it credit conservation—as I have just discussed. But a prolonged regime of credit drought and soaring interest rates might persuade me to go the next step toward quantitative restraints on credit such as those proposed by Albert Wojnilower of First Boston: marginal capital requirements on banks, down payment and maturity controls on installment and mortgage debt, and the like.

By the way, it surprised me yesterday at a meeting of a bank board of directors in Minneapolis that the majority of the board were at the point right now, a private banking board, of feeling that we were about ready for quantitative controls in the credit field.

Well, another area that at least one should put in a good word for, even though it is politically unrealistic, is wage-price restraint. It may be whistling in the wind to suggest that some kind of wage-price guidance be coupled with a policy of prudent monetary-fiscal restraint. Precisely when inflation pressures are ebbing rather than rising, however, will such restraints have the best chance of being observed and taking hold, especially if tipped with some tax carrots. And I think that, harking back to our 1962 experience, was what helped us put those wage-price guideposts into effect, namely, that they were put in before inflation had really jumped, as it did later in the 1960's and 1970's.

Let me just conclude with a few comments about the Reagan administration bind. It is beginning to recognize that its new, new, new economics of gains without pains is simply not viable. It is vexed by high interest rates. Witness the Reagan-Regan statement in the September 21, 1981, issue of Fortune: "That we can have and should have some loosening of interest rates because they're now contributing to the inflation we're trying to cure." Or Mr. Stockman's statement early

this month in Joliet: "The Reagan revolution is being jeopardized by these oppressive interest rates."

The White House is also puzzled and vexed by Wall Street's reaction to a program "that isn't even going into effect until October 1," as they constantly remind us. What in the world did this administration, which pinned much of its hopes on great expectation, expect from the citadel of rational expectations in Lower Manhattan?

The Reagan White House can't seem to make up its mind whether to stick to its new supply-side faith and go for strong growth, with all its scary implications of higher inflation and higher interest rates. Or whether it should go for the old-time religion of slack and recession, with all its dreary implications of bigger deficits, higher unemployment, lower profits, and stunted investment.

There is no easy way out of this dilemma. But recognizing it for what it is and opening the administration's mind to a balanced approach embracing not just budget cuts, but tax increases, credit guidance, and some White House appeals for wage-price restraint could improve both the economic outlook and the climate of expectations. Thank you.

[The prepared statement of Mr. Heller follows:]

PREPARED STATEMENT OF WALTER W. HELLER

I appreciate the Committee's invitation to discuss some of the vexing problems that the U.S. economy faces today, problems reflected in sky-high interest rates, sagging securities markets, soggy investment, and a sputtering economy.

Grim reality is beginning to replace the false hopes and illusions of Reaganomics. It was to be alluringly easy: cut taxes to the bone, sharply boost defense spending, and rely on the Federal Reserve (and supply-side miracles) to put a damper on inflation.

It was not the conservative "old-time religion" of putting the economy through the wringer by restrictive fiscal-monetary policy to squeeze inflation out of the system. Instead, we were offered the radical "new faith" that Reaganomics could simultaneously deliver robust growth, ebbing inflation and interest rates, and balanced budgets. No hard choices, no tough trade-offs in the economic wonderland that zealous supply siders and monetarists -- united in shotgun marriage -- offered the Reagan White House. It was, and is, unreal.

What are the realities that now emerge out of the President's tax and budget-cutting victories and the triumph of monetarism in Federal Reserve policy?

- Towering deficits: For the next five years, tax cuts of $750 billion* coupled with over $150 billion of added defense spending will simply swamp the roughly $250 billion of budget cuts thus far enacted. Even taking proper account of the "fiscal drag" from automatic growth in federal tax revenues, this is an overly stimulative fiscal package. The CBO estimate of a $50 billion deficit by 1984 is at the low end of a forecasting range that runs up to $100 billion.
- Towering interest rates: In spite of a current down tic in interest rates, a tight-fisted Federal Reserve policy clashing with an expansionary fiscal policy and a stubborn inflation

*These are on a sharply escalating curve, rising to $150 billion a year in fiscal 1984, $200 billion in 1985, and $268 billion in 1986.

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rate will keep interest rates on a high plateau as far as the eye can see (unless and until the economy slumps badly).

- A fits-and-starts economy operating, on the average, below its potential. Three years of next-to-no growth -- real GNP at the end of 1981 will be only marginally (about 2%) above its level at the beginning of 1979 -- have already been offered as a sacrifice on the anti-inflation altar. And a progressive slowdown in monetary growth pledged by the Fed and supported by the White House will nip future expansions, if not in the bud, long before full bloom.

That these realities should come as a surprise to the White House and the financial markets is itself surprising. To be sure, interest rates are higher and the tax cut, because of myriad special-interest provisions and indexing, will be more costly than anticipated in the out years -- former Defense Secretary James R. Schlesinger puts it rather well, if a bit strongly, when he says that the 1981 tax is "likely to go down in history as the single most irresponsible fiscal action of modern times" -- but the inherent contradictions of Reaganomics were apparent long ago.

Let me take the shortcut of quoting some excerpts from my March 19 appraisal, "U.S. Economic Policy and Outlook" (co-authored by George L. Perry and published by the National City Bank of Minneapolis):

> "The basic problem with [the Reagan] approach is that is is internally inconsistent. In the absence of any direct attack on the price-wage spiral, one cannot expect brisk recovery, receding inflation, and falling interest rates to co-exist."

> "The Reagan plan . . . puts an expansionary fiscal policy on a collision course with a contractionary monetary policy. Indeed, there is some basis for the impression that Mr. Reagan is relying on fiscal policy to boost demand and speed recovery, monetary policy to curb inflation, and supply-side policy to promote long-run economic growth."

> "But unfortunately, the economic world does not work in this neatly compartmentalized way. Fiscal stimulus will expand jobs and output, but it will also tend to prop up prices and wages. Tighter money and higher interest rates will cut into demand inflation but their main impact will be to cut into jobs and output, . . . and discourage investment. And supply-side responses will be far too weak to lead the economy out of this dilemma.

> "If Fed policy holds to its indicated policy of containing nominal GNP growth, the Reagan economic scenario is seriously flawed: neither nominal nor real GNP will be allowed to grow as fast as that scenario projects. And both deficits and interest rates will be higher than projected. The conflict is fundamental: until inflation is substantially lower, monetary policy as currently targeted will frustrate Mr. Reagan's 'new right' policy for economic expansion."

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The major focus of today's economic frustrations is found in interest rates that keep setting new highs not just in nominal terms, but in real terms. Before considering some methods of damage control, it may be useful to remind outselves of the extensive damage that high interest rates are inflicting on the economy. If those interest rates are the price of curbing inflation, that price is mighty high indeed.

Among the damaging impacts and high costs of our towering interest rates, one should bear in mind the following:

- Impact on level of economic activity: The most obvious impact of unrelenting monetary restriction is the suppression of economic expansion. In a sense, it is hard to blame the Fed for this. The Reagan Administration has no anti-inflationary program of its own (except for some long-run impacts of deregulation and investment stimulus). In fact, it has a pro-inflationary fiscal program. The job of curbing inflation and in the process taking the zip out of economic expansion, is assigned to the Fed.
- Impact on investment: The conflict between fiscal and monetary policy is typified even more sharply in the area of business investment. The most generous tax breaks for savings and investment in U.S. history -- now adding up to one of the most liberal tax treatments of investment in the industrialized world -- show no signs of being able to overcome the stultifying effect of high interest rates in 1981-82. The recent Department of Commerce survey, confirmed by The Conference Board survey, shows business fixed investment flat in real terms for 1981-82.
- Impact on housing and autos: The brutal blow to these industries is so well documented as to require no comment.
- Impact on thrift institutions, small and medium business, and state-local governments: Here again, forced mergers of savings and loan companies, a rising tide of bankruptcies, and shattering impacts on state-local borrowing are all too apparent.
- Impacts on foreign economies: Our high interest rates are forcing restrictive policies on our trading partners that account in significant part for their stagnant economies. The LDCs are also finding the refinancing of their dollar debts a grievous burden.

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- Impact on cost inflation: As monetary policy pushes money costs to business and home buyers into the 18% to 25% range, one cannot ignore the fact that its role in damping down demand inflation (which, incidentally, has not been our problem since 1979) comes at an ever-increasing price of higher cost inflation. The rise in net interest burdens of non-financial corporations is one case in point: from an average of $40 billion a year in 1976-79, that burden rose to $56 billion in 1980 and was running at a rate of $62 billion in the first half of 1981. (One might note that this huge debt burden tends to give business a vested interest in inflation -- a sudden drop in price advances in the face of soaring fixed charges on business debt would put a tremendous squeeze on profit margins. What we are witnessing is a transfer of the risks of inflation from the lender to the borrower.) The other case in point is that of mortgage financing costs -- now exceeding 18% -- which have a magnified impact on the consumer price index.
- Impact on the budget: Interest costs are the fastest-rising and least-controllable major component of the federal budget. As against an 11% rate of increase in the budget as a whole, and 15% for transfer payments, interest costs have been rising at an annual rate of 19% in the past decade. For fiscal years 1981 and 1982, ballooning interest rates represent a significant part of the ballooning deficits that are leading to such intense pressure for budget cuts.

It is already apparent that super-high interest rates operate with sharply differential impacts on various segments of the economy. It is worthy of special note that there is a fairly systematic bias as between the economically strong businesses and individuals that can in good part shield themselves (or actually profit) from high interest rates and the economically weak units that bear the brunt.

As CBO puts it in its September 10, 1981, report, The Economic and Budget Outlook, (page 33):

> "For business firms and individuals in high income-tax brackets, real after-tax interest rates may not have risen sufficiently to dampen their business activities severely. The impact varies greatly, however, depending on the tax situation. For business firms that have little or no profits, the real costs of borrowing are significantly higher."

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Even more patently, high interest rates form a part of a pattern of shifting burdens from the upper to the lower income groups that is now in process. Granted, high interest rates stack the deck against the poor and near-poor in somewhat more subtle ways than denying them net tax cuts (while conferring generous tax cuts and lavish "tax expenditures" on the well-to-do) and cutting CETA, food stamps, Medicaid and the like. First, they are hurt as net debtors or would-be debtors who want to buy a car or house. Second, they will be the primary targets of further budget cuts required to offset the unanticipated rise in interest-related costs ($10.3 billion between March and July and another $5-$6 billion since July). And third, monetary restriction used as a more traditional anti-inflation instrument to curb inflation by slack and slow growth will put those at the bottom of the unemployment ladder once more into the front lines of our defenses against inflation.

And it should be recognized that the cutbacks in social programs arising out of the grinding combination of excessive tax cuts, big defense boosts, and high interest rates are not just a human issue but an economic issue. Diminished investment in infrastructure, in health, safety, education, training and research, ignores the true secret weapon of 20th Century American economic growth, namely, investment in human capital. The recent Conference Board Colloquium on Alternatives for Economic Policy -- while agreeing on the necessity of budgetary trimming, deregulation, and stimulation of business capital formation -- returned to this theme again and again. As the report on the Colloquium, U.S. Economic Policy Issues for the 1980's, stated: "A pervasive feeling, running through the record of the Colloquium, is that the issues of human capital in the United States have received much too little attention for much too long a time." There was deep concern with the problem of putting "more emphasis on human capital development as a necessary complement to measures to encourage more physical capital investment." All told, Reaganomics has been moving in the opposite direction.

Before turning to some reasoned steps that might be taken to improve the interest rate outlook, one should perhaps refer to the supply-siders' remedy for our economic problem. The most vocal and strident of their number demands, first, the public flogging of Beryl Sprinkel (Undersecretary of the Treasury) and, second, a return to the gold standard. I regard the two proposals as equally plausible and desirable.

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The gold standard is offered, in effect, as the ultimate discipline for monetary policy, for keeping the Federal Reserve on the straight and narrow path of relentless monetary restriction. It would apply the old-time religion with a vengeance requiring such monetary stringency in the face of inflation as to plunge the economy into a Thatcher-like depression. And with gold supplies expanding only about 1.5% to 2% a year, a strict gold standard would condemn the world to a grindingly slow average rate of growth. Or, if the United States were to go it alone on the gold standard, the inflows and outflows of gold (controlled in part by South Africa and the Soviet Union) would give us anything but monetary and economic stability. (I recognize that various discretionary devices could be built into the gold-exchange standard to avoid thus being crucified on a cross of gold. But by the time the various exceptions are built in to avoid the most brutal impacts of a rigid gold standard, why go to gold?)

Along what avenues can we hope to find some relief from the relentless regimen of high interest rates that the logic (or illogic) of Reaganomics is fastening on us?

- The Fed itself should now be in a position to show a little self-restraint in pushing for further monetary restraint. Granted, it is mighty hard to read the money supply tea leaves (one of the inherent defects of monetarism). But with M-1B (both adjusted and unadjusted) running below the Fed's targets (even with M-2 running a bit above), there seems to be some technical leeway for a bit of relief. Also, with overall economic activity relatively sluggish, and with favorable breaks on the inflation front (oil, food, and housing prices, and import prices being the main cases in point), some letup in federal credit stringency is now in order. This would not relieve us of the basic contradiction in Reaganomics, but would allow some easing of interest rates in the short run.

  Budget cuts: Some further cuts are already scheduled by the White House to be part of the program to relieve pressures on the Fed and to allay the fears of the financial markets (which have since June lost nearly $200 billion in stock values and $300 billion on debt issues). But the going will

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tough, in the political sense of breaking faith with those, in Congress and out, that have been promised a vigorous defense buildup and those who had been assured (or thought they had been assured) that severe further inroads on social programs were not on the White House agenda.

Tax increases: In the light of these constraints, the pressure for tax increases will and should grow. Removal of some tax preferences or tax expenditures should have high priority. Elimination of the deduction of interest on consumer debt could bring in $6 billion a year. A $5,000 lid on deduction of mortgage interest could add another $4 billion. Including half of social security benefit payments in taxable income (for taxpayers with incomes above $15,000) would yield $4-1/2 billion a year. Some limit on the exemption of contributions to employer health plans; application of withholding to interest and dividends; a serious drive to bring the underground economy above ground for tax purposes; elimination of tax deductions for State retail sales taxes paid -- these and other measures would yield substantial revenues while improving equity and resource allocation.

Also on the revenue agenda should be higher user fees, e.g., in commercial aviation, waterways, irrigation projects, and boating; a windfall profits tax on deregulated natural gas; and boosts in excises on liquor, tobacco, and gasoline.

Rescinding the third-year 10 percent tax cut and eliminating tax indexing would be major moves toward more responsible budgeting and lower deficits. Politically feasible? Probably not. As a result, there will be growing talk of a progressive value-added tax in the next few years.

Credit guidance: Although one shies away from direct credit controls, a few words to the wise from the Federal Reserve Board to the banking community could help conserve the existing money supply and direct it to productive rather than nonproductive investment. Surely, an Administration that has no hesitation in providing multiple tax guides to investment, savings, and the like should not find it inconsistent to go along with some credit guidance.

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I am not yet ready to go beyond such gentle credit guidance -- or perhaps one could call it "credit conservation" -- as I have just discussed. But a prolonged regime of credit drought and soaring interest rates might persuade me to go the next step toward quantitative restraints on credit such as those proposed by Albert Wojnilower of First Boston: marginal capital requirements on banks, downpayment and maturity controls on installment and mortgage debt, and the like.

Wage-price restraint: In the present political climate, and given the current easing of inflation, it may be whistling in the wind to suggest that some kind of wage-price guidance be coupled with a policy of prudent monetary-fiscal restraint. Precisely when inflation pressures are ebbing rather than rising, however, will such restraints have the best chance of being observed and taking hold, especially if TIPped with some tax carrots.

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The Reagan Administration is in a severe bind. It is beginning to recognize that its new, new, new economics of "gains without pains" is simply not viable. It is vexed by high interest rates. Witness the Reagan-Regan statement in Fortune (September 21, 1981, issue), "That we can have and should have some loosening of interest rates because they're now contributing to the inflation we're trying to cure." Or Stockman's statement early this month in Joliet: "The Reagan revolution is being jeopardized by these oppressive interest rates."

It is also puzzled and vexed by Wall Street's reaction to a program "That isn't even going into effect until October 1." What in the world did this Administration, which pinned much of its hopes on Great Expectations, expect from that citadel of rational (?) expectations in Lower Manhattan?

The Reagan White House can't seem to make up its mind whether to stick to its new supply-side faith and go for strong growth, with all its scary implications of higher inflation and higher interest rates. Or whether it should go for the old-time religion of slack and recession, with all its dreary implications of bigger deficits, higher unemployment, lower profits, and stunted investment.

There is no easy way out of this dilemma. But recognizing it for what it is and opening the Administration's mind to a balanced approach embracing not just budget cuts, but tax increases, credit guidance, and some White House appeals for wage-price restraint could improve both the economic outlook and the climate of expectations.

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Senator KENNEDY [presiding]. Thank you very much, Professor Heller, for a very eloquent and revealing analysis of the current economy and for the constructive suggestions and recommendations which are included in your analysis.

You mentioned in your prepared statement that interest rates are contributing to inflation, rather than restraining inflation. Could you develop that point? We hear a great deal in the committees of Congress that maintaining high interest rates is the best way to dampen the fires of inflation. You make the opposite point. Could you elaborate a little bit on it?

Mr. HELLER. I'm happy to do that because, of course, we, as economists, look to monetary restriction—monetary restraint, along with fiscal restraint, as an essential part of the long-run anti-inflation program; and there's no question that if you make money a lot more expensive and less available that there's less wherewithal with which to bid up prices. But I think there are two things that need to be said.

One is that the nature of our inflation in the past 2 or 3 years has not been excess demand inflation. We have not had too much money chasing too few goods. It's been, rather, the other way around. We have a pervasive, long-run inflationary problem and, indeed, if we put the economy into a tight monetary noose long enough and ran at recession and depression levels, there's no question that demand inflation would be subdued and eventually that would turn into a more modest, hard-core inflation of lower wage and price adjustments.

However, I think both the world of economists and the world of finance are becoming much more aware of the fact that there's another side to that coin, and the flip side is the contribution to cost-push inflation, both in terms of the tremendous thrust of interest rate costs and—and I cited the great growth in corporate costs, and one can bet one's bottom dollar that corporations will adjust prices upward to cover those costs, and then you take the impact on the consumer price index, magnified by the way we measure the CPI and particularly the thrust of mortgage interest rates which have a disproportionate influence on the CPI, and that too contributes to rather than reduces inflation.

So that while I'm not abandoning the basic economic concept of monetary restraint as part of the weapons against inflation, I think we have pushed it to a point where there are growing offsets in terms of cost inflation thrusts from the supply side.

Senator KENNEDY. You refer in your prepared statement to the Reagan economic program as being a start-stop policy, with an expansionary fiscal policy and a tight monetary policy. It appears that on the one hand you're putting the gas pedal down on the car and on the other hand you're putting your foot down on the brake. We have a schizophrenic economic policy.

What does that mean for us in terms of continued high interest rates and the possibility of reaching a balanced budget?

Mr. HELLER. Well, it seems to me we have seen somewhat of an illustration this past year of a tremendous zig-zag performance with big jumps in GNP followed by sharp drops, and then kind of a stagnation, kind of a comatose economy that we have now, just being drugged by high interest rates.

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I believe that the fiscal thrust next year, especially after July, will provide a quite powerful expansionary force in the economy. And then comes the question: How much of that thrust, how much of that expansion would be permitted by the Federal Reserve which is dedicated to a continual reduction in money supply growth?

That, by the way, Senator Proxmire, is one of the great differences between our 1964 situation and the one today. At that time, with enough slack in the economy—and we had 1.2 percent inflation per year, not per month, so that we were able to couple a strong fiscal thrust with an accommodating monetary policy, and the consequence was that we had expansion right up until the outbreak—the escalation of war in Vietnam in mid-1965. We had that strong expansion with no increase in inflation. It went up from 1.2 to 1.6 percent inflation per year, mostly the result of an increase in farm prices.

Here we don't have that fortunate situation. We are in this bind of extremely high interest rates to begin with and every time we get any amount of thrust in the economy, especially with no wage-price restraint, the only weapon we have got—the only game in town is the Fed, and they are going to tromp on the brakes and that's what I mean by fits and starts of expansion.

Senator KENNEDY. Chairman Volcker yesterday indicated quite clearly to the members of the Budget Committee and to the Congress that the Federal Reserve is going to continue the policy of monetary restraint. It appeared that his attitude really reflects a "Damn the torpedos, full speed ahead," mentality. The question that obviously comes to all of us from our constituents is, What are we going to do about these high interest rates, and are we going to let the Federal Reserve run the economy right off the edge of the cliff, particularly with regards to housing, small business, farmers, and others who are most affected by it?

What's the answer you think we ought to give them?

Mr. HELLER. Well, let me say, first of all, I'm glad I don't have to be answering your constituents because the answer is a tough one. The answer is that as long as the Reagan program continues on an undiminished course of expansion through these gargantuan tax cuts, through tremendous defense spending increases, and nowhere near matching budgets cuts—and I'm not advocating a tremendous budget catharsis here—but as long as the administration pursues that course and refuses any kind, as I say, of credit guidance, wage-price guidance and refuses to contemplate some tax increases to offset those huge deficit-generating tax cut, you can't really blame the Fed for maintaining a tough stance.

Now I don't think it has to be quite as tough as they are currently doing in light of economic conditions, in light of the fact that money supply growth hasn't been all that rapid relative to their M–1B targets, but nevertheless, they are put in the position of being the only defense we have against an inflationary spurt. So that for the longer run, there's no easy way out unless the Reagan administration provides the leadership to change course.

Senator KENNEDY. Let me just finally ask you this, Professor Heller—there has been a great deal of talk around here about Wall Street being to blame for the failure of the economy to respond in the way predicted by the Reagan administration. It seems at least

to some that it isn't Wall Street that's to blame. They are just the messenger bringing the bad news about the schizophrenic economic policy, and about the lack of sufficient revenues over the next several years to offset the budget deficits.

If we repeal the indexing provisions of the tax cut, what would be the reaction within Wall Street? What is the relationship between deficits and interest rates? At other times in our history during the Ford administration, for example, we had significant deficits but dramatically lower interest rates. Perhaps you would comment on both these questions—the problem of indexing and the relationship of large deficits to high interest rates.

Mr. HELLER. Well, let me say that you're asking me to interpret Wall Street. I want you to just bear in mind that I'm an economic analyst, not a psychoanalyst, and that I can't account for some of Wall Street's reactions.

At the same time, I can't say that they are reacting illogically at the present time in light of the huge deficits that are built into the program. The hope that those deficits might gradually disappear after 1984–85 it seems to me have been wiped out by the adoption of indexing. I think that was a mistake. I think that the indexing takes some of the sand out of the gears that generate inflation. I think that it has perverse cyclical impact. It means that just when inflation is worst you cut taxes the most when you really ought to conserve your revenue firepower, during that period. And I feel that it puts the Congress in kind of a straitjacket. Congress has over the years in effect indexed the income tax by making judicious tax cuts from time to time. To cement indexing into the law was a major mistake.

So what's happening today is that Wall Street fears there's no end in sight to the deficits, no end even when the economy is returning to reasonably full operations. This means that "crowding out"—crowding out, which was a favorite term with which the conservatives belabored the Carter administration—becomes a vicious reality when the Federal Government is likely to be dissaving—and that's what a net deficit is after all, is net dissavings—as much as $60, $70, $80, $90 billion a year in the outyears. In light of those looming deficits, Wall Street, the financial community—and that's about a $5 trillion community, it's not just a narrow street in Lower Manhattan, as Henry Kaufman points out, it's a $5 trillion industry—is saying "We don't see how those total demands for credit can possibly be met with the available supplies of saving without huge, long-run projected high interest rates."

Whatever I may say about the occasional illogic of Wall Street, I think that's very good economic logic.

Representative REUSS [presiding]. Thank you. I welcome Senator Mattingly and would like to recognize you as soon as I've asked a few questions.

Senator MATTINGLY. Thank you, Mr. Chairman.

Representative REUSS. And then Senator Sarbanes.

I was very taken with your entire statement, Mr. Heller, and think it does indeed offer a constructive course to get us out of the trouble we're in. I'm particularly interested in what you have to say about credit conservation. I think that's a good word for not squandering what is a very, very scarce commodity—credit.

Would you disagree with the following Tom, Dick, and Harry analysis of why we have such abominably high interest rates: That basically it's a question of supply and demand. The supply of money is being constricted by the Federal Reserve somewhat unduly; not all that much, but somewhat unduly restrictive? On the demand side, there are two very hiked up grabbers of credit who bid up the interest rate—one, the U.S. Treasury which, poor soul, has to do so because it is faced with unconscionable and continuing deficits; and, second, the speculators, the conglomerate takeover artists, the Bunker Hunts with their silver corners, the marginal foreign loan lock jockeys and so on?

For example, seven of the biggest banks in the country are still grubstaking Bunker Hunt for more than a billion dollars in his ill-fated attempt to corner the silver market. A small businessman or a capital investor who actually wants to put in productivity enhancing machinery would have loved to have gotten his hands on some part of that and, as you know, the wave of mergers and takeovers is almost unprecedented and very largely credit financed with some of them by foreign loans.

I noted with interest your saying that your bank in Minneapolis is a regional bank—it services the needs of people in the Twin Cities in the Minnesota area, the businessman, large or small, who wants to expand, the farmer and the merchant. Your bank directors didn't seem disturbed at the idea that this Nation should not be the only Nation in the industrialized world to squander its credit. I suspect that the reason that I and others get absolutely nowhere in persuading the Federal Reserve and the administration to embark upon the modest kind of credit conservation you're talking about is because the 50 biggest banks in the country—or the 100 biggest banks, the money market banks—are the ones who are doing most of the squandering. They are the ones that are grubstaking Bunker Hunt. They are the ones who are grubstaking the conglomerate takeover artists. They are the ones who do more business in the far reaches of the world than they do back in America. They brag about their man in Singapore, but you never hear them say much about their man in Sheboygan who has a hell of a time getting a loan.

Wouldn't you agree it's about time to lift the shades off the eyes of the American people about the unholy alliance between the big banks and the Government and the Fed so there can be a constructive debate on whether we really have to inevitably go on in the way we are going with super high interest rates for the worthy borrower?

Mr. HELLER. Well, my guess is, Mr. Chairman, that continuation of high interest rates and tight money is more likely to lift those shades than anything you or I can do in the current—what should I say—political philosophical environment. After all, we are paddling upstream. The watchword these days is no interference with the private market, a diminution in every respect of the role of Government, and this idea of credit guidance or credit conservation simply runs counter to those apparent trends in philosophy.

As I say, I feel the administration fails to recognize that it's practicing enormous guidance through tax measures and so forth and that there's no consistency there. I don't think some credit guidance would be inconsistent, but I'm afraid that we are fighting at the moment a losing battle. But a continuation of present credit conditions will per-

haps change minds about this and when you have people in the financial community itself, people like Wojnilower, beginning to question, beginning to recognize that merely controlling the supply of money isn't doing the job and that you might have to go to some kind of actions on the demand side of this equation, that kind of recognition I think will be growing. For that matter, we have heard some of it from Republican Members of Congress and that's a bit of progress, too.

Representative REUSS. Wouldn't you say that the administration is not doing those things which it ought to do but is doing those things which it ought not to do. For example, as of October 1, it's going to offer a tax-exempt certificate to the banks, of all people, mainly the same banks who have been misallocating as it is, and take that money away from the municipal bonds and corporate bonds, which in the one case keeps our cities alive and in the other case gives a corporation some chance of maybe buying a new machine tool once in a decade?

How can this be? Isn't this Alice in Wonderland-like?

Mr. HELLER. Yes. I think the all-savers certificate is just a ghastly mistake, but let's not call it just a White House mistake. The Halls of Congress are reverberating with a fair amount of blame.

Representative REUSS. It is with shame that I report that in this case it was the Democrats who caused the spectacles of the Congressmen to cloud over with emotion because we proposed it, but it doesn't make it any better.

Mr. HELLER. Well, Mr. Chairman, it's like so many tax expenditures. Yes; it will provide some relief, some succor for savings and loans which are in bad shape, but it does it at enormous expense. It goes the way that so many tax preferences go, namely, in order to help the group that it's really designed to help, it has to be spread out and offered to others as well, for example, to the commercial banks who are not in need of the help.

And then I think there's the further point that it doesn't get to its ultimate target of helping housing at all, or very little, because that money can be invested in FNMA instruments and have very little impact on housing. It's going to provide some relief for savings and loans and savings banks and commercial banks and very little of it will filter through to support housing.

So I agree that this is a very expensive, very misguided attempt and, as you point out, it's an alternative to investment in tax-exempt municipals. It will certainly, for the time being, make them less attractive and they are already paying these incredible 13, 14, and 15 percent interest rates, tax exempt.

The all-savers aren't going to be a long run problem if they are allowed to go out of existence after the 15 months, but they are a further interference with the very difficult problem of financing State and local capital projects and for that matter meeting State and local deficits.

Representative REUSS. Senator Mattingly.

Senator MATTINGLY. Thank you.

Mr. Heller, I just have a few questions. I assume that you think that what you term as Reaganomics is a failure; is that correct?

Mr. HELLER. I'm sorry, I didn't get the question.

Senator MATTINGLY. I assume that you consider Reaganomics a failure; is that correct?

Mr. HELLER. Oh, it's too early to make any final judgments, Senator, on Reaganomics. I think you have to make kind of a rolling judgment.

Senator MATTINGLY. It's too early then?

Mr. HELLER. No. I'd say you can already judge partially—you have to judge it by what it has promised and what is happening. It's already had to abandon the idea that through expectations—through improved expectations we would have lower interest rates. It's had to abandon its forecasts both of lower interest rates, and to hear the Secretary of Commerce Baldrige tell it, it's had to abandon its forecast of economic growth for next year.

Senator MATTINGLY. What now? Somebody abandoned their what?

Mr. HELLER. Secretary of Commerce Baldrige has already gone public with a forecast of economic growth next year which is way below the initial target or assumption or projection of the administration.

Senator MATTINGLY. Are we having more economic growth projected next year than this year?

Mr. HELLER. Secretary Baldrige has a little bit higher growth next year, year over year, than this year, but nothing like the 4 or 5 percent that the administration projected. So you have to make these judgments in two kinds of steps. One, what was projected; what was promised; what's happening? And, second, what are the markets, financial and otherwise, telling us about the future relative to the future projected by the administration?

Senator MATTINGLY. I won't beat up on Wall Street and the financial markets. I think everybody's beat up on them already.

Mr. HELLER. I'm not suggesting that we beat up on them.

Senator MATTINGLY. I won't. I think they've got their job to do to make comments like anybody else, but I think there are a lot of people in this country, more numerous even in the financial areas as far as what it means to generate growth in the country, that are probably more positive toward the program than possibly they may be, but they are concerned. To get back to high interest rates, I think the question I heard asked here about why we have high interest rates or what is the answer to their constituents, I don't think it's even a question that needs to be asked in here. I don't think that's your responsibility and I wouldn't ask you to do this, to answer to my constituents. I think that's my problem.

The high interest rates didn't just start in the last 2 months. It seems the correspondence spread out by people about the high interest rates for the last 2 or 3 months is like it just started. It didn't just start. I think you'd agree with that. When I was out in the private sector before I became a Senator last January I owned my own business and I was aware back then that we had high interest rates. So it didn't just develop overnight and I would probably say if we didn't have the 5-week recess and we had all stayed in session we probably wouldn't have gotten uncontrolled in the area of the media with all the experts coming out and taking shots at the program at that time.

But my question, I guess, is the one thing that you understand there that you mentioned about revenue fire power, that it put the Congress in a straitjacket. In other words, the loss of the revenue firepower. Is what your saying there the loss of tax revenues puts

us in the Congress in a straitjacket because we won't be able to spend as much?

Mr. HELLER. No; I'm not talking merely in terms of the impact of lower flow of tax revenues on expenditures. I'm talking about economic policy management, as it were, and the enactment of huge tax cuts, plus, indexing, does remove a lot of the congressional flexibility and, for that matter, administration flexibility in managing fiscal policy for economic stabilization, expansion, and anti-inflation purposes.

Senator MATTINGLY. But there's a term that you used about revenue firepower, but I think that to me is very significant when you talk about a loss of revenue firepower. How do you generate revenue firepower in our country? I disagree with a lot of people when they say we need a tax increase because what I think is how you generate revenue firepower is by putting growth on. How do we create growth? It hasn't been decreased—inflation hasn't been caused by an increase in taxes. You know as well as I do what's happened over the last 4 or 5 years with the tax increases we've had in our country, and this really hasn't had an impact upon increasing the growth which would have in fact increased the revenue firepower, and I'm just saying, isn't it really a—can I just be about as right that the odds would be about 50–50, that I feel like the cut in the taxes is going to create growth in our country, as well as maybe you saying cutting the taxes are not going to create growth in our country?

Mr. HELLER. Well, Senator, surely I don't need to underscore the fact that I have been for tax cuts for a long time, even in the current situation, and I think the prudent tax cut, properly structured, was exactly what this economy needed. I'm talking about a tax cut that, as I noted in going over my statement, will be costing us $150 billion in 1984, $200 billion in 1985, and $267 billion a year in 1986. And what I'm talking about is not that we should not have taken off some of this overburden of taxes that was holding us back, just as in 1962 and 1964 we did it. On the contrary, I have been strongly in favor of that as an aid to economic growth and particularly to the growth of investment. I felt we needed investment incentives and stimulus.

But I think the way the tax cut came out is excessive and I think it's injudicious and imprudent to enact a 3-year tax cut before we know whether we can validate that by lowering inflation and lower budget spending, and that's my objection to the program, not to the tax cuts per se.

Senator MATTINGLY. The loss that you're talking about in revenue is on the expectation there isn't going to be any growth?

Mr. HELLER. Oh, no, not at all. Those are the official projections by the Joint Committee on Taxation of the revenue losses. Those numbers I was just giving you are not something taken out of a hat somewhere with very low growth projections, not at all.

Senator MATTINGLY. Well, saying they are good figures; then I would go on to say that probably if anybody's figures are good figures, maybe the figures of the Reaganomics are and what we're projecting in growth could be good figures also, and I was pleased to see the other day the CBO report where they were more upbeat, the report that Alice Rivlin gave, which I think is a sign that's not been publicized that greatly in our country and probably because it was upbeat. It did

show that growth was going to increase next year, that inflation was going to come down, that the unemployment rate would be stationary and maybe decrease slightly, and she made a positive sign, at least CBO did, that it appeared that the interest rates would be declining, which I think is, to me, for CBO, quite optimistic.

Mr. HELLER. You're absolutely right.

Senator MATTINGLY. And let me just add one little aside to that.

Mr. HELLER. Sure.

Senator MATTINGLY. Because I've heard a lot of negative comments and the private sector needs a light at the end of the tunnel of the high interest rates. They're not saying that they expect the interest rates to go down at 2 p.m. on December 3. All the private sector is saying is say that the interest rates will begin declining in the fourth quarter or the first quarter of next year at a gradual rate and be optimistic that that may happen. So many times we give off so many negative statements that no only discourages them but many things happen in the news media that become gospel that may not be gospel according to the arithmetic.

Mr. HELLER. May I respond to that?

Senator MATTINGLY. Yes.

Mr. HELLER. First of all, what Wall Street seems to be saying is that the light at the end of the tunnel isn't daylight; that's a train roaring in from the other end and that train is labeled huge deficits.

Now coming back to Alice Rivlin's forecast, let me say that I have enormous respect for both her competence and her objectivity and I think that CBO has done a remarkable job in bringing the—shall I say—the intellectual firepower of Congress in the budget process to a level of equivalence with the administration.

At the same time, let me report, so that we put it in perspective, that when Alice Rivlin sat with us on the Time magazine board of economists a week ago Tuesday, she had by all odds the most optimistic scenario of any of the members of that board, including Alan Greenspan and Martin Feldstein and others. So while I respect very highly the projection she's made, I think it should be recognized by Members of Congress that they are very much at the optimistic end of the private forecasting spectrum, both on interest rates and on inflation and on growth.

Senator MATTINGLY. Well, I agree with you and I know my time is just about up so I'll give you my slip of paper back saying my 10 minutes is up, but the conclusion that I want to make and that I would hope that you would agree with is that there needs to be not so many negative statements given off and I think that all along maybe we've gotten up here and I have in the past and ridiculed some figures that have come out of CBO and I admit that, but at the same time, when they come out with optimistic signs—and you have sat on the other side at times and said CBO has pessimistic figures—we don't need necessarily to be constantly trying to find things wrong all the time but maybe trying to get into the optimistic mood and maybe considering that maybe the revenue firepower of the U.S. Congress will be restored by this new type of economics that will generate growth and jobs and increase the paychecks and have a decline in inflation and it's just conceivable that it's going to work.

Mr. HELLER. That's a consummation devoutly to be wished. By the way, I find myself in a rather peculiar position to the extent that you

were directing your comments at me of being put in the position of being a pessimist in this situation. Around the turn of the year I published an article in the Wall Street Journal pointing out the underlying economic strengths of this great country and trying to give a lie to the Reagan claim that we were in the worst crisis in postwar history in the economy. So I posed there as the optimist and the Reagan administration as the pessimist.

Representative REUSS. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Heller, first, I want to thank you for some very tough minded analysis which I think was contained not only in the prepared statement but your response to some of the questions. I'm frank to tell you that I think the key phrase in your entire statement was on the last page when you talk about the balanced approach, and it seems to me that quite clearly there is no balanced approach. On the monetary policy that is now the case. It's so far out of the normal range of people's ability to cope that it really is bringing certain sectors of the economy to a complete halt.

Now there are different approaches. Some of us thought the administration cut too deep domestically—we think we need to prune the tree but not dig it up by its roots—that and were too openhanded in defense. We need to do things in defense and they seem now to recognize that themselves, although I don't know to what extent they are going back to look at that. The tax cut should have been more targeted, limited. Actually, you could add all of that up in a way that would have given you a more restricted fiscal policy than the one that is now in place; and it seems to me, had that been done with at least an implicit understanding with the Federal Reserve, that you could get a workable monetary policy where the rates would perhaps come down somewhat. The testimony presented to the subcommittee suggested that if people could function in the 12- to 14-percent range, although that's expensive money traditionally in this country. The 13.8-percent financing has apparently made possible increases of some automobiles although manufacturers have put a lot of pressure on their dealers to pick up part of that cost. But there would have been an overall balanced fiscal and monetary package, one portion with another portion.

Because of the interest rate the administration is now going to lurch back the other way. We're talking about $100 million in cuts, again some in programs which contribute to economic development and jobs rather than hinder them, when it seems to me that an overall balanced approach, relating fiscal and monetary policies and giving us levels in each area that people could work with, would have been perceived as a rational response that would enable us to work our way through the situation.

Let me now go on to another observation. In this area a medium-priced home can now be afforded only by people with incomes in the top 5 to 10 percent of the income scale. In other words, to buy a medium-priced house, in the middle of the market, you must have an income at the top of the income scale, and that's almost entirely attributable to the high carrying charges that come from high interest rates. This leads me to a further observation.

A lot of the small businesses that are going out of business, the auto dealers, farmers who are getting out, are not marginal enterprises. Those went long ago. These are established, effective, productive, economic enterprises with a long history of functioning in the community and making an important contribution and they just can't cope with the current situation. In one way or another, they are either closing up. Actually sometimes they say, "well, we'll close up and put our money into the money market funds and take that return," without their having it produce anything in terms of their daily economic activity.

I'm concerned that the situation may be bringing about two very fundamental changes in the American economy. One is a two-class economy. To some extent, there are signs of what used to be the European model—where only those at the very top or close to the top of the income scale can afford what we have assumed generally the public could afford, autos, houses, and so forth. The other change is taking place in the economic structure, in terms of the concentration of power, because you squeeze out the small businessmen and the smaller concerns which are a very valuable part of our economic sector. The bigger fellows are in a better position than the smaller people to ride out this situation, and the smaller people are simply being squeezed to the wall. If this is not changed rather quickly, it presages undesirable developments in both of these directions—one for the two-class economic society, and the other toward a greater and greater concentration or economic power. I wonder what your comments on that would be.

Mr. HELLER. Well, first of all, I think one should count, as you're implying, as one of the costs of this sky-high interest rate policy the snuffing out of a significant number of small businesses that provide a a lot of the yeast, as it were, for American enterprise, that provide a lot the jobs, that provide a lot of competitive threat to larger businesses; and I think all of us know of people who in the face of today's interest rates simply folded or have decided they can't make a go of it. And in that sense I feel what you're saying about a two-tier economy, those that can and those that can't protect themselves against high interest rates—and I refer to that in my statement—I think that has a growing reality. We will pay a very heavy price for that, and not apparent in the kind of catalog of costs that I put in my statement.

So I have a lot of sympathy for that point of view.

Senator SARBANES. Couldn't the Federal Reserve, even under its existing authority, indicate some credit guidance to the banking community with respect to their continuing to make enormous lines of credit available for corporate mergers and takeovers, simply pointing out that in most instance they do not accomplish some productive economic purpose? It represents a shift of assets in financial terms but it does not represent an economic difference. Yet a good part of the available credit is being consumed in such undertakings. We have just been through the Conoco affair, where three or four purchasing groups each obtained enormous lines of credit in order to engage in that takeover bid.

Mr. HELLER. There are two comments. It seems to me that a few strategically placed phone calls by Paul Volcker to key members of the big banking community could work wonders in terms of this kind

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of guidance that we're talking about. But that seems to run (a) against the current thinking of the Federal Reserve and (b) against the antitrust thinking of the administration.

There seems to be in the Justice Department a good deal more tolerance for mergers, a good deal less questioning of monopoly and oligopoly and corporate concentration. I don't think it's quite so openly avowed, but one gets a whole lot of signals indicating that the sky is the limit. In that kind of a setting, if there should be a disposition on the part of the Fed to do anything about discouraging mergers, that might well be a considerable discouragement. I don't find any disposition to do that in the Fed or the administration. Yet, it would be a very helpful move to do precisely that.

Senator SARBANES. The administration has gotten some help on the inflation fight from developments in particular sectors; especially energy costs, and to some extent food. That could change, of course, and then we would have a much more difficult inflationary situation to confront. I think your point that we have not been running, as it were, in an excess demand inflationary situation but have significant resources, human and plant and equipment sitting idle, is a good one.

You mentioned the wage-price restraint matter and I appreciate the framework in which an issue of that sort is considered, but what kind of wage-price guidance do you think could be engaged in that would be constructive and helpful in trying to moderate the inflation situation?

Mr. HELLER. Without going into too much detail, it seems to me if we set up a set of guidelines for a gradual deceleration of wage and price advances over the next 4 or 5 years and backed that up with TIPS, with some kind of tax incentives, tax carrots for those who comply. It's more difficult now than it would have been; we had lots of revenue leeway to do that before we passed the Economic Recovery Tax Act of 1981, to provide some rewards for those who comply with those guidelines, especially on wages. That approach should be coupled with fiscal and monetary restraint—not substituted for—that's something we as economists constantly have to keep harping on—we are not proposing that you let up in the basic sense. I don't mean that you want to keep interest rates where they are now. You need more fiscal restraint than you've got and you need a little less monetary restraint than you've got and you need to translate the resulting reduction in demand, not into less jobs and less output and less profits, but into lower wage and price settlements, and that I think could be done.

It's difficult. It's not going to be easy. It's going to be sloppy around the edges. We want to avoid all-out mandatory controls at all costs, but I think we could have a much more successful prospect for de-escalating inflation if we had that kind of coupling of wage-price guidance with monetary and fiscal restraint.

Senator SARBANES. My time has expired. Let me just close with this observation. I read a long article in the London Economist quite a while back making the point that Helmut Schmidt spent about 50 percent of his working time as Chancellor of West Germany engaged in discussions, consultations and meetings between government, business and labor in order to arrive at a concensus with respect to both public and private economic policy and particularly a concensus on price and wage movements, and that a good deal of their success in dealing with

that question is attributed to this extended consultative process and the direct commitment of both time and attention on the part of the Chancellor.

Mr. HELLER. Yes. Wouldn't it be wonderful if Ronald Reagan, who is a great communicator, that disarming leader we have in the White House, would devote part of his—I was going to say 8-hour day—there is some dispute as to the length of his workday—I don't know whether it's 5 or 12 hours—but if he would devote a considerable part of his day to trying to develop some kind of a social compact with big business and big labor. It's not as easy as in Germany. Germany starts with the predeliction and a history of modest wage settlements, high savings and so forth, and it's much easier to get the leaders of business and labor together with the central bank and the central government and that's been called more formally the concerted action, and they have had a successful incomes policy of a very informal sort for a long, long time.

And so even if the Reagan administration were totally opposed to going to something as formal as I have just proposed, concrete guidelines, tax incentives and so forth, I think this President, who after all has very winning ways—the Congress should be more aware of that than anybody—if he would devote some of that towering talent to get across to business and labor that they have a responsibility, especially after all the things that have been done by way of tax cuts and so forth by the Federal Government—they have a responsibility to work towards this kind of more stable environment. I think he would have a chance of making some real progress.

Representative REUSS. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Heller, let me get back to the Rivlin Congressional Budget Office estimates and compare them with yours. They have estimates for the next 3 years for growth in the GNP, for the inflation, for the GNP price deflator, for the unemployment rate, and for interest rates—the 3-month Treasury bill rate.

Now, you have indicated your respect for Ms. Rivlin and for the Congressional Budget Office and their objectivity, you have indicated also that she seems to be much more optimistic than most of the private economists are.

Her real GNP estimate—and I'd like to have yours for it—is a growth of 3.1 percent next year; 4.1 percent in 1983; 4 percent in 1984. Now I have to admit, although I have been very critical of the failure of this administration to balance the budget, that if they can get that kind of real growth, that's a pretty good performance. That's better than we have had on the average throughout our history. We've grown about 3 percent, I understand, throughout the years. That's better than that 3 percent and it's something that I think the administration could say is worth the program we're going through.

Mr. HELLER. Well, let me say this, that it's not better than the record of postwar economic recovery. They have generally been characterized by 2 or 3 years of more rapid growth than that. So it's not even——

Senator PROXMIRE. Well, we're not in a postwar period right now. The Vietnam war has been over for some time.

Mr. HELLER. I mean, even in the seventies recovery, the average has been at an even faster clip than that. So I'm reinforcing your point

that while it's not—while it's somewhat above the average experience, it's not inconsistent with things that have happened in the past.

The problem is that we start from a point of departure of so much higher rates of inflation and interest rates that it just doesn't seem plausible if we're going to contain—if we're going to contain inflation and particularly with monetary policy being virtually our only weapon—it doesn't seem plausible that those rates of expansion can be sustained for very long.

Senator PROXMIRE. That's what puzzles me about her's. I'm glad to get your criticism.

Her next point is the implicit price deflator—they estimate the GNP implicit price deflator at 9.1 inflation on that measurement in 1981. In 1982 it goes down to 7.7. It drops again in 1983 to 8.7 percent. It drops in 1984 to 6.6 percent. Again, a relatively good performance, though we would all like to see it drop faster and further, but I think we would have to say that's a success if we could get a program that would both have a growth of reasonably comparable with our historical record, no recession, a growth of 3 or 4 percent and a moderation of inflation.

What's your reaction to that possibility?

Mr. HELLER. Well, I don't think that it is inconsistent within the next 18 months to expect some stepup in the rate of growth and some stepdown in the rate of inflation. That happened in 1975–76, a strong upward growth as far as GNP was concerned, and a considerable reduction in inflation.

Senator PROXMIRE. And you see that happening in spite of the fact that we're going to have a fiscal policy that's quite expansionary and a growth that would reflect that?

Mr. HELLER. I see that happening for two reasons. One, so much of our inflation has been sort of special factor, external shock inflation, and some of that is oil, food—food is a little uncertain. At the moment we're getting the benefit of the strong dollar in terms of import prices and there's some softening of housing prices, more softening than is reflected in the CP because many people are holding up the prices of their housing but they're giving breaks on the financing which essentially are a price reduction. So that's part of it. That permits us to have some inflation reduction coexisting with the expansion of the economy.

A second factor is that we are far below full utilization of our resources and as we make more effective use of our existing resources and as we make more effective use of our existing productive capacity, both labor and machinery and equipment and plant, as utilization rates rise in manufacturing, we will get some improvement in productivity.

Senator PROXMIRE. Now you just said 18 months. Alice Rivlin goes farther than that. She goes 3 years. Do you thing it's fairly realistic that we can sustain a continued easing of inflation at the same time we have a substantial growth in the economy 2 years after that?

Mr. HELLER. We have had awfully good luck this year and unless there are some disasters in the Middle East or in the farm segment, I think we could continue to have some improvement and I think some of that—and I go along with Paul Volcker on that—some of that will be reflected in the reduction of core inflation next year. Wage

settlements will be a little lower, but that 's an improvement, Senator, of 1 to 2 percentage points. We're not talking about a tremendous——

Senator PROXMIRE. She estimates the CPI even more optimistically. The CPI in 1981, 10 percent in 1982, 7.2 percent; in 1983, 7 percent, in 1984, 6.2 percent. That's a drop from 10 to 6 percent over a period of 4 years and it's, of course, a pretty healthy improvement; isn't it?

Mr. HELLER. It's a pretty healthy improvement and it's not impossible, but it's unlikely.

Senator PROXMIRE. You think it's unlikely?

Mr. HELLER. I think it's unlikely if we permit the tax cuts to go into full effect and have their stimulative effect on the economy and thereby invite the Federal Reserve to step on the brakes again.

Senator PROXMIRE. Well, let me proceed then. The unemployment rate she sees falling steadily also, moderately but steadily; 7.4 in 1981, 7.3 in 1982, 6.9 in 1983, and 6.5 percent in 1984. You can't throw your hat in the air over that, but that's an improvement, and we have to acknowledge that improvement. It would mean, again, that the Reagan program was succeeding to a limited extent. Do you think that's unrealistic?

Mr. HELLER. It's optimistic, Senator. I expect that we will have some improvement in the unemployment rate later in 1982, but with the present combination of policies, I think we will have much more of a fits and starts kind of pattern. I don't think we will see this progressive easing that's projected here, and I thought that the CBO and Alice Rivlin were very careful to note that this was based on certain assumptions with a wide range of possible error in those projections. Things don't develop as neatly as table 3 in her testimony, which I believe you're reading from, would suggest.

Senator PROXMIRE. That's right. Then, the final conclusion is that interest rates would drop from 14.5 percent this year to 12.4 percent in 1982, to 11.4 percent in 1983, to 10.1 percent in 1984; again, a moderate and encouraging improvement. Ten percent interest rates historically is scandalously high, but on the basis of what we have now it's pretty good.

Mr. HELLER. Yes; pretty good. Out there is 1983 and 1984, that's about four points above the administration's projections. This is again possible, but I have to say again, given the policies that we have in place, it seems to me we will have a significant zig-zag picture of interest rates around a very high plateau unless we make fundamental changes in the mix.

Senator PROXMIRE. Let me say this, I want to get something else in quickly. I don't have much time left. As we have indicated, I don't think there's a better economist than you are and there's certainly no better communicator than you are as an economist. You are the best. But I was disappointed that you said absolutely nothing in your presentation about cutting spending of any kind—military, space, revenue sharing, Eximbank, public works, so forth. There was no indication that you felt there was any—that I could get—maybe I missed it. Maybe you put it in there and I missed it. I didn't see any indication, however, that you felt we should cut spending. Your proposals would knock the hell out of the automobile industry and out of the homebuilding industry. Elimination of the deduction of interest and consumer debt, a $5,000 lid on deduction of mortgage

interest. Brother, if I were in the homebuilding industry, I'd say it's bad enough as it is; what do you want to do with us?

Mr. HELLER. I want to reduce interest rates.

Senator PROXMIRE. Well, you don't reduce interest rates by putting in effect a real increase in interest rates after you pay your taxes; $5,000 sounds like a whale of a lot of interest to pay, but anybody now buying with a $50,000 mortgage, that's $8,500 in interest, and you would have $3,500 of that that has a tax on it which it doesn't have now. So they would be paying higher taxes and, of course, the $50,000 home is cheap these days. The average is $70,000. So a $5,000 lid would result in a higher real rate of interest from the person who is buying a home. It would be harder for them to do it.

Mr. HELLER. What I'm suggesting is that as part of a more balanced policy that would rely on fiscal—I was going to say fiscal restriction—the cutback of the excessive fiscal stimulation, you would be able to reduce interest rates and what you might lose in the swings you would gain in the roundabouts. I would think the housing industry would be better off for this balanced program in spite of the fact that you take away their deduction of installment loan interest and cut back a little bit the mortgage loan interest.

Senator PROXMIRE. Both homebuilding and automobile sales are so enormously important in the credit sector that it's hard for me to see that you could design an effective restraint program that wouldn't do injury to them. If you let them go, it would be less effective. If you tried to include them, it seems to me you would kick them when they're down.

Mr. HELLER. Well, this is where discretion is the better part of valor. What you would want to do is discriminate in such a way that the credit-starved parts of the economy would be given access to funds, those that we regard as important to the economy, whereas you take the funds——

Senator PROXMIRE. With a few exceptions—the corporate mergers certainly is one and speculation is another, and they are important, but they are relatively minor compared to these other areas—every other area in the economy is credit-starved now. You and the chairman had a very excellent exchange. I thought, on what happens with the all-savers certificates and how that drains money away from other areas. Once we start fooling around with credit wouldn't it do damage one place or another? And there's a lot of pain here that we're going to have to push on somebody.

Mr. HELLER. You want to mete out the pain to those segments that don't contribute to productivity and to constructive economic elements in the economy.

Senator PROXMIRE. I agree. I just think they are rather limited.

Representative REUSS. Senator Jepsen.

Senator JEPSEN. Thank you, Mr. Chairman.

Mr. Heller, I find myself agreeing with a number of the things that you said and not agreeing with others, which I guess is not atypical. I have a general question, first of all.

Do you feel that the proposed economic recovery program by the President as laid out over the period of time that he has expressed it would run, 3 years, with the four main legs on this program being (1) of control of Government spending in a broad sense, (2) the

restructuring of the tax system, (3) to reform the regulatory agencies, and (4) a stable fiscal policy—do you basically disagree with that program?

Mr. HELLER. Not qualitatively. In other words, I don't think there is any one of those four planks of the platform or four legs of the stool, as long as you don't have a fifth leg with gold standing under it—but I don't think there's any one of those things that one would disagree with. I don't want to take part of your time, Senator, but just a quickie in response to your point that I didn't make much of the budget cut question. I did put budget cuts in here. I have my own hit list. I think there are things that ought to be cut. I think that there are still items that I would feel would be quite legitimate for budget cutting. It's just that that didn't seem to be the main focus of my attention this morning.

So to come back to your question, Senator, in qualitative terms, no objection.

Senator JEPSEN. Well, I get the feeling that we have the situation here where the things that have happened in the last 3 weeks by way of a general concern for high interest rates, which is a specific aggravating real life financial situation that exists, that it should not detract—as it has panicked some folks even in my own party to do, unfortunately—from the big picture, the picture that we have an economic recovery program. The basic parts of it are not all wrong. It was not meant to happen in 35 days. After all, it took us a good number of years to get in the position we are in and that we need a series of balanced moves at this time to approach the aggravated situation which is very serious of the high interest rates that we have at the present time, but still keeping in mind that we shouldn't scuttle either verbally or otherwise the entire program.

I understand politically or whatever they call it—the responsible opposition—things have picked up speed on criticizing this program, but I want the record to show that it is basically still correct. We are in a position here in the country where we find ourselves in kind of a hot room where we buy an air-conditioner and immediately start tearing things apart and saying it isn't cool yet when the air-conditioner hasn't been delivered.

It took us, as I say, some time to get this way. It reminds me of the fellow who said, "Lord, give me patience and I want it right now." And I would point out, first of all, I want to—for good relationship reasons, I want to say to you that our comment about budgets alone won't do it, I think essentially that's what you said, and I couldn't agree more. The facts of life are that, first of all, the interest rates today are lower than they were in December of 1980. So it's a little difficult to say these are Reagan interest rates.

Having said that, I would also point out the interest rates today are at the same level they were in May and we have cut on record and publicly substantially, and actually since May, as far as the budget is concerned, and it hasn't had the effect of driving interest rates directly downward. I think it's a very integral and important part, but in and of itself it is just that, because there are inflationary expectations and a lot of psychology, as you know. Different economists say somewhere between four and six points of inflationary expectation. Savings and loans and banking institutions have said, we're sorry we didn't understand that sooner and include that in our long-range rates. So we are

all learning something. We are going through what is called the economic recovery program and it's tough. The underground economy also—I don't think you would find any disagreement anywhere that's something that's been around. Also it's increased according to all the figures, or maybe we're just discovering it now and that's something we've got to get at. But meanwhile, back where we are at today, the interest rates.

If we're going to reduce them, I think it has to be done by a series of balanced moves at this time which handle this so-called economic shark infested waters we're swimming through on a short-range basis to keep things going while we keep our eye on the total picture which is 3 years down the line of bringing this all together at once.

Chapter XI's are running rampant in this country and I don't underestimate the seriousness of high interest rates. Do you feel that a combination of a moderation of monetary policy, some additional budget cutting, an expedited regulatory reform moves—would those three things simultaneously—there are some others, but just starting with those three things—would those three things be a good sign?

Mr. HELLER. Well, the basic question I have, in response to that question, revolves around the word "balanced" that you used. In other words, I was saying qualitatively we are all in favor of those four objectives, but what happened was with the tax cuts we just completely went overboard. We overdid it and that's what the financial markets are saying. I think the expectations that the administration had hoped to be favorable to rates of inflation, the rates of interest and so forth, have simply been tossed into a cocked hat by that excessive combination of getting big tax cuts and a promise of a big defense buildup.

I would think that merely promising further draconian budget cuts—and remember, to get a balanced budget by 1984, even on Alice Rivlin's quite optimistic assumptions, would take $50 billion of additional budget cuts per year. I don't think the combination of budget cuts and regulatory relief and—what was the third item in your program——

Senator JEPSEN. I'm not advocating it, but taking a look at some possible moderation of the monetary policy.

Mr. HELLER. I don't think that's enough, you see. I think that, first of all, it would require budget cuts that go way beyond what I think is good for either the social programs or the defense of this country.

Senator JEPSEN. Are they wrong steps? What else would you add, or you wouldn't even start with these?

Mr. HELLER. I think there are things we can do. I think, for example, just to take a couple of examples, this is a politically sensitive area, but the way we index social security benefit payments, that could be changed. We have overindexed it.

Senator JEPSEN. You think the formulas and so on we're talking about now of possibly looking at the CPI and so on are something in the sense of fairness and reality ought to be looked at. Is that what you're saying?

Mr. HELLER. I think that's right. When you have increases of 13 percent and 14 percent in social security benefit payments when labor is only getting 8 percent or 9 percent more in wages, then you really have a question of whether you're maintaining a fair balance between the working and the nonworking population. This doesn't raise the question of whether the levels to begin with are correct, but if the levels

to begin with are correct, then we are overindexing. The veterans benefit payments, non-service-connected disabilities, the hospital costs and so forth—I'm talking about cows that are apparently still very sacred, but if we're going to have further budget cuts, I could list a series that probably would make most Members of Congress choke, but would, to my mind, be fair and equitable.

But what I'm getting at is I don't think these moves, and particularly these moves in terms of what is politically realistic and fair and equitable to the victims of the cuts—I don't think those moves are enough. I think we need to go beyond that to some tax increases and I outline a whole series of possibilities in my statement. I never felt it was sound to go for a 3-year tax cut to begin with, to put that on the books. That's an open invitation to spending by individuals rather than saving and I don't think it's fiscally prudent to dish out huge tax cuts before we delivered the budget cuts and the de-escalation of inflation that makes those cuts viable.

So I think we need to take action on that front and I believe some kind of credit guidance, and if one could do it, some kind of persuasion on the part of this very persuasive President for business and labor to go a little easy. Government is curbing itself. We are curbing ourselves on the monetary front. We ought to curb ourselves more on the fiscal front, and I think the President would be in a good position to ask for moderation in wages and prices on the part of labor and business. So I think you need a broader program than the three-ply one you suggested.

Senator JEPSEN. I thank you. I have been advised my time has run out, even though some of the time was taken with discussing with Senator Proxmire. I would just simply say——

Mr. HELLER. I'm sorry to intrude on your time.

Senator JEPSEN. Many things you say—I find many economists—and I have talked to a lot of them in the financial area, as you might well guess. We have been having constant meetings because of the concern that's real, and that's there, that everybody is aware of it. We have to be totally insensitive if we weren't aware of the interest rates being what they are, the fact is that we are going to work very hard to try to keep the eyes of the country focused on the goal, the end goal, and the fact that you indicated that these tax cuts have been disastrous. I would hasten to point out that the tax cuts haven't gone into effect yet and it's your fifth-level economists up in Wall Street that are wrong 99 percent of the time and are most verbal and most verbose with leaders of Wall Street sitting back on their hands and we're going to do something about that too because the people in this country want to do whatever is necessary to save this economy of ours because, as I say, it didn't get this way in the last 7 months, but that's going to take some working together and the critic can kill a play and very few critics are the right one today, and I appreciate many of the comments you have made today have been very constructive and, frankly, as I say, I agree with a number of them.

Mr. HELLER. Thank you, Senator.

Representative REUSS. Mr. Heller, we are confronted, of course, with this second budget resolution and the year we're talking about is good old fiscal 1982 which starts in a couple weeks, and we've got to do something. I'm not going to ask for your views on the military budget

and the degree of cuts that are possible because that's the President's and Congress' responsibility and I don't know that much can be done to alter that.

Mr. HELLER. I just would say, if I may interject, that I wish something could be done about—what shall I say—the comparative standard of living in the military world versus the civilian world. I'm just afraid that there's an awful lot of gold plating. I know there's a problem of keeping the Volunteer Army employed in the Army and in the Navy and the Marines and Air Force and so forth, but our second home out in the State of Washington is right next to the Trident submarine base and I look at the standard of living, whether it be athletic facilities or four-lane roads or what have you—I look at the standard of living inside the base and outside the base, and it just seems to me there's lots of room for cuts without crippling or curbing the defense position of this country, and I can't understand why "Mack the Knife" can't apply a little of the scalpel—not the meat axe—to those military expenditures, but I wanted to deliver myself of that.

Representative REUSS. That's probably going to be done in the next few weeks. You did say you had a hit list of expenditures which could be cut in the short term. Can you either now or when you go over your testimony give us such a reasonably quantified list?

Mr. HELLER. The quantification is difficult, but with some general orders of magnitude I could do it when I go through the testimony. I have suggested a couple of them already. I would include tax expenditures.

Representative REUSS. Of course, I'm going to come to those in a minute, but for now, what about straight, old, regular expenditures? I think Senator Proxmire perhaps overdoes it a bit, but there are a few things that he mentioned that could well be stricken.

Mr. HELLER. Like the maritime subsidies and, at the risk of never going back to Minnesota, I would throw in some farm subsidies, and I think there's a considerable list that political considerations aside—after all, you're not asking me to take on the onus of the Congressman or Senator in such a list—could be cut out of the budget without great economic consequences and without any real inequity either. Standards of living, so to speak, on some public programs are a good deal higher than they need to be. I surely would not include in that list a lot of the cuts that have already been made. We keep hearing that the easy cuts have been made. I'd like to know what the victims of those cuts think. I think we have already gone beyond the fat and into the muscle on a lot of the programs that were cut to date and so I'm not suggesting that those are good candidates for further cuts.

Representative REUSS. So what we've got is a somewhat fraudulent $42 billion predicted deficit and now everybody admits for 1982 it's going to be greater. How much greater, heaven knows. You're saying that you could probably squeeze another billion or two out of nonmilitary expenditures without creating undue suffering?

Mr. HELLER. Well, I could find $5 billion without a great deal——

Representative REUSS. $5 billion?

Mr. HELLER. Of course, putting them into effect for fiscal 1982 starting 2 weeks from now, that's very tough.

Representative REUSS. That's what we're talking about.

Mr. HELLER. Much of that is locked in and so I'm not suggesting there's much of an easy out for fiscal 1982.

Representative REUSS. Well, fiscal 1982 is the big problem in my view. If you could get fiscal 1982 under control, as I tried to do in our tax bill, we could have achieved a balanced budget. If we could get fiscal 1982 under control, interest rates would come down because the determination to get control of the budget would then be apparent by actions. Even though the affluent might quake in their boots because the paradise that was promised them in 1986 may not come to pass, in terms of quieting down the money markets, I think you would be quite successful.

Mr. HELLER. I don't know what you suggest under control should be defined as—holding the budget deficit at $50 billion instead of $60 or $70 billion?

Representative REUSS. Well, let's say holding it between $40 and $50 billion, just to be very realistic.

Mr. HELLER. But I don't think that's very realistic in terms of what you can do between now and then, if it's really headed toward $60 to $62 billion, $20 billion above the White House figure. I don't see how you're going to find ways and means of cutting as much as $15 billion out of that budget.

Representative REUSS. Well, let's talk about it.

Mr. HELLER. Perhaps it can be done.

Representative REUSS. I said cut civilian expenditures an additional $2 billion. I think the President wants to cut the military a totally inadequate $2 billion in fiscal 1982.

Mr. HELLER. It's $13 billion over 3 years. I'm never quite sure, by the way, whether the White House is talking obligational authority or whether it's talking actual outlays. Is that $13 billion actual outlays?

Representative REUSS. Anyway, lots of Republicans are now expressing alarm over the swollen military budget. Let's say we could get $5 billion off of that in fiscal 1982; $2 plus $5, that's $7 billion. So the rest has to come, whatever the rest is, out of tax expenditures, et al. Let's see what one can do, looking at your prepared statement, toward elimination of interest on consumer debt, $6 billion. Well, Senator Proxmire is probably right that that would cause the vendors of Mercedes and Alfa Romeos much distress because the people who deduct that interest are the upper 20 percent of the population, not the nice old Joe who buys a clunker. But anyway, the point is to eliminate interest on automobile loans. You still get about $3 billion. On the mortgage interest, incidentally, I think you have been fairly noble this morning. It turns out, according to your testimony, that you have a second home, and you deserve it, in the State of Washington. You know, you would be interfering with your interest rate deduction and asking that the taxpayers refrain from subsidizing you in your bucolic delights.

Mr. HELLER. That's right. I would even go so far, perish the thought here in the Halls of Congress, as to limit property tax deduction to only one home, but that's considered—I don't want to destroy my reputation as a moderate——

Representative REUSS. You could perhaps get Proxmire off your back a little bit on that by changing the $5,000 lid to a primary home. After all, the principal home concept is used in our law now with respect to energy tax credits, with respect to shifting upward of a

home. You can only do that on your principal home. So that might fly. It's pretty hard to defend people's condos in the Rockies and their cottages at Newport and all the other third, fourth, and fifth homes they have.

Mr. HELLER. The last time I made that proposal I was forceably reminded by the chairman of the committee before which I was appearing that many Congressmen and Senators were forced to maintain two homes.

Representative REUSS. Right, and maybe imposing this crown of thorns on us would enable us to accompany it by a much needed and long delayed salary increase, so we could perhaps handle that.

Now, you say that adding, into the tax base half of social security benefit payments to taxpayers above $15,000 would yield $4.5 billion a year. I don't see why that isn't flyable. It really is a ripoff.

Mr. HELLER. Absolutely.

Representative REUSS. Why should you get, with all the dough you make, a tax-free $6,000 or $7,000 a year? You will one of these years, if you don't now.

Mr. HELLER. No; that's right. I don't know whether I would quite characterize my situation as you just did, but there's no reason that that kind of deduction should be allowed at all.

Representative REUSS. Regarding exemption of contributions to employer health plans, I think the same way as you. On your withholding on interest and dividends, that I would not include in my list simply because, administratively, it's so tough to abstract that dividend payment going to the widow and orphan and then trying to get it back 18 months later. We might have to argue about that.

On the underground economy suggestion: well, that's good, but you can't do it in 2 weeks. On the elimination of tax deductions for State retail sales taxes, I think that's eligible for immediate inclusion. And then your user fees proposals are almost all good—commercial aviation, waterways, irrigation projects, yachts and so on. Even the administration asked for those, and then when Congress coughed a bit they hastened to run for cover, but they should be made to reinvigorate that one. Boosts in excises on liquor, tobacco, and gasoline—well, it's good enough for Helmut Schmidt and Margaret Thatcher, it ought to be good enough for us. Our gasoline tax is 4 cents a gallon. Italy's is $2 a gallon. You could have a nice little exemption for the worker who needs that gas to get to and from work, because he should get a rebate.

I'll bet we've got almost $15 billion of doable things there. So why not do it, bring interest rates down, reduce the swelling in Wall Street, make everybody happy?

Mr. HELLER. I would say absolutely, full speed ahead. It would improve the fairness of the tax system and it would improve its impact on resource allocation. The offset against that is political pain, but I think on general criteria of taxation and fiscal policy it's almost all gain and no loss.

Representative REUSS. On that note of hope, let us thank you all very much for a splendid presentation.

We stand adjourned.

[Whereupon, at 12:25 p.m., the committee adjourned, subject to the call of the Chair.]

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